EXHIBIT I

UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT

No. 85-1932

GERALD M. HOCKING,

Plaintiff-Appellant,

v.

MAYLEE DUBOIS and VITOUSEK & DICK REALTORS, INC.

Defendants-Appellees.

On Appeal from the United States District Court
for the District of Nevada

BRIEF OF THE SECURITIES AND EXCHANGE COMMISSION, AMICUS CURIAE, ON REHEARING EN BANC

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STATEMENT OF THE ISSUE

Whether the sale of a condominium apartment, where the buyer may apply to participate in a rental pool managed by a company that has no affiliation or selling arrangement with the condominium seller, constitutes the sale of a security under the federal securities laws.

INTEREST OF THE SECURITIES AND EXCHANGE COMMISSION AND SUMMARY OF ITS POSITION

The Securities and Exchange Commission, the agency principally responsible for the administration of the federal securities laws, submits this brief as amicus curiae to address an important question concerning the coverage of the federal securities laws. The Commission believes that the panel's

decision in this case, which is being reheard en banc, improperly construed the reach of those laws in a case involving the sale of residential real estate. The Commission is particularly concerned because the panel reached its decision based in considerable part upon a misunderstanding of the Commission's position as stated in a 1973 Commission release.

This case concerns the resale of a condominium apartment in a resort complex in Hawaii. The developer of the complex had offered the original condominium purchasers the opportunity to participate in a rental pool. A rental pool is an arrangement whereby an agent is responsible for renting and managing all apartments that participate in the pool, and each owner receives a pro rata share of the rental income (less the agent's fee). A sale of a condominium by a developer who also provides a rental pool normally constitutes the sale of a security.

The resellers of the condominium here had chosen not to participate in the rental pool when they purchased their condominium from the developer. Nonetheless, in connection with the resale, a real estate agent informed the prospective buyer that the buyer could apply to participate in the pool. He subsequently applied and was accepted. The buyer sued the real estate agent and her employer under the federal securities laws for damages allegedly caused by fraudulent misrepresentations made by the agent relating, for the most part, to the value of the property. At issue is whether the sale of the condominium

constituted the sale of a security. The panel concluded that the sale of a condominium as to which there exists an optional rental pool always constitutes the sale of an investment contract, and hence the sale of a security, even where, as appears to be the situation here, there is no affiliation or selling arrangement between the condominium seller and the rental pool operator.

The Commission believes that neither the case law nor its 1973 release supports this conclusion. The investment contract test set forth in SEC v. W.J. Howey Co., 328 U.S. 293 (1946), requires an investment of money in which profits will be obtained from the efforts of others. An investment of money in the purchase of a condominium is not, in itself, a securities transaction, nor is the independent procurement of management services from others. In this residential real estate transaction, we assume, based on our review of the record, that there was no affiliation or selling arrangement between the condominium seller or the real estate agent and the rental pool operator. As a result, the condominium sale and the pooling arrangements were two separate transactions, and the sale was not covered by the federal securities laws.

The panel determined that a Commission release published in 1973 (Securities Act Release No. 5347, 1 Fed. Sec. L. Rep. (CCH) para. 1049 (Jan. 4, 1973)), "compel[led]" its conclusion that the investment contract test was satisfied here. The Commission

disagrees. That release applies to "persons engaged in the business of building and selling condominiums" who offer a rental pool "coupled" with a condominium. Id. at 2070 (emphasis added). In other words, the release was intended to apply to developers who, as is often the case in resort complex developments, make available a rental pool for condominium purchasers. The sellers here, by contrast, were not developers, and they could do, and did, nothing more than, acting through a real estate agent, inform the purchaser that an entity with which they had no affiliation or selling arrangement provided a rental pool. The release did not conclude that such a condominium sale is the sale of a security.

STATEMENT OF THE CASE

A. Facts 1/

The plaintiff, Gerald Hocking, a Nevada resident, purchased a condominium apartment from Tovik and Yaacov Liberman, who are not parties to this suit, through defendant Maylee Dubois, a licensed real estate agent. At the time, Dubois was employed by defendant Vitousek & Dick Realtors, Inc., a Hawaii real estate agency. The condominium was located in a Hawaiian resort complex developed by Aetna Life Insurance Company. As part of the original development, Aetna offered purchasers the opportunity to participate in a rental pool arrangement. The rental pool,

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1/ The statement of facts is taken from the opinion of the court of appeals.

which was managed by the Hotel Corporation of the Pacific, was optional, and the Libermans had elected not to participate.

In urging Hocking's purchase, Dubois told him of the availability of the rental pool arrangement. The purchase of the condominium gave Hocking the right to apply to the pool operator to participate in the rental pool. Hocking applied, and his application was accepted approximately two weeks after he purchased the condominium. The rental pool arrangement was to take effect six months later.

B. District Court Proceedings

Hocking filed suit in the United States District Court for the District of Nevada against the real estate agent, Dubois, and her employer, Vitousek & Dick Realtors, Inc. He alleged misrepresentations by Dubois relating for the most part to the value of the condominium, and sought recovery under the antifraud provisions of Sections 12 and 17 of the Securities Act of 1933, 15 U.S.C. 77l and 77q, and of Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder, 15 U.S.C. 78j(b) and 17 C.F.R. 240.10b-5. He also asserted certain state law claims.

The district court entered summary judgment in favor of the defendants on the securities law claims, and dismissed the pendent state claims for lack of subject matter jurisdiction. The court based its decision on its conclusion that the sale of the condominium did not involve the sale of a security. Hocking

had argued that the offer of a rental pool made the condominium sale an investment contract. The court, however, stated that "the mere representations by the defendants that there was a rental pooling agreement available which the plaintiff could enter into if he saw fit to do so subsequent to purchasing the property, is insufficient to establish a cause of action against these named defendants." (Appellant's Excerpts from Record on Appeal at 44).

C. The Panel Decision of this Court

Hocking appealed the district court ruling, and a divided panel of this Court reversed and remanded for further proceedings (839 F.2d 560). The panel held that if Hocking's allegation that the real estate agent had offered him the option to participate in the rental pool was true, the sale of the condominium satisfies the criteria for an investment contract set forth in Howey and its progeny.

The panel based its decision, in considerable part, on its interpretation of Securities Act Release No. 5347, 1 Fed. Sec. L. Rep. (CCH) para. 1049 (Jan. 4, 1973), in which the Commission set forth guidelines as to the application of the investment contract test to the offer and sale of condominium units. The panel noted that Release 5347 described three rental arrangements, one of which involves a rental pool. As to such an arrangement, the release states that "the offering of participation in a rental pool arrangement" brings the

transaction within the scope of the investment contract test. Id. at 2072. The panel, in view of the release, stated that offering a condominium with a rental pool "automatically makes the investment a security." 839 F.2d at 565 (emphasis in original).

The panel went on to hold that, even apart from the release, the offer of the condominium satisfied the Howey test, which requires that there be an "(1) an investment of money, (2) in a common enterprise, (3) with the expectation of profits produced by the efforts of others." Id. at 564. The panel analyzed each of these factors. First, the sale of the apartment involved an "investment of money." Id. at 566. Second, a rental pool involves a "common enterprise," because "the success of each participant's individual investment clearly depends on the entire [rental pool's] success." Id. at 567. Finally, an "expectation of profits produced by the efforts of others" exists "whenever a condominium is sold with [a rental pool] option." Id. (emphasis in original). The panel therefore remanded the case to the district court to determine whether Hocking was, as he alleged, offered an "option" to participate in a rental pool. Id. at 562 n.1.

In a dissenting opinion, Judge Hug concluded that the transaction did not involve the sale of a security because the seller had "no connection whatsoever with a rental pool." 839 F.2d at 572. In addition, Judge Hug stated that the majority's

conclusion is based on its incorrect premise that Hocking was offered an "option" to participate in the rental pool. He stated that there is "no evidence in the record that even suggests an option was offered," and the seller did not even have a "transferable 'option' to enter the rental pool that was binding on the developer * * *." Id. (emphasis in original).

The defendants petitioned for rehearing en banc. This Court granted the petition on August 1, 1988.

ARGUMENT

THE SALE OF A CONDOMINIUM APARTMENT DOES NOT CONSTITUTE THE SALE OF A SECURITY UNDER THE FEDERAL SECURITIES LAWS WHERE THE SELLER HAS NO AFFILIATION OR SELLING ARRANGEMENT WITH THE RENTAL POOL OPERATOR.

A. Unless there is an affiliation or selling arrangement between the seller of a condominium and the rental pool operator, the condominium sale and the procurement of management services are two separate transactions, and the condominium sale does not satisfy the Howey investment contract test.

Section 2(1) of the Securities Act, 15 U.S.C. 77b(1), and Section 3(a)(10) of the Securities Exchange Act, 15 U.S.C. 78c(a)(10), both define "security" as including "investment contract." The leading case on the meaning of "investment contract" is Howey, which defined an investment contract as "a contract, transaction or scheme whereby a person [1]invests his money [2]in a common enterprise and [3]is led to expect profits solely from the efforts of the promoter or a third party." 328

U.S. at 298-99. 2/ When real property is sold as a residence or without management services, the transaction ordinarily does not involve the sale of a security. See, e.g., United Housing Foundation, Inc. v. Forman, 421 U.S. 837 (1975)(sale of cooperative apartments by nonprofit corporation, where purchasers sought to acquire a place to live, does not involve sale of a security); Joyce v. Ritchie Tower Properties, 417 F. Supp 53 (N.D. Ill. 1976)(condominium to be occupied by buyer as his residence); Dumbarton Condominium Assoc. v. 3120 R Street Assoc., 657 F. Supp. 226 (D.D.C. 1987)(seller of condominium apartments did not promise to market, develop, sell, or lease the property on behalf of the buyers); Mosher v. Southridge Assoc., Inc., 552 F. Supp. 1231 (W.D. Penn. 1982)(buyer had sole discretion whether or not to rent out condominium and no rental pool offered).

Where, however, real property is sold with management services, courts have found the investment contract test to have been satisfied when the management services were provided either by the real estate promoter or by an entity having some affiliation or selling arrangement with the promoter. See, e.g., Howey, 328 U.S. at 295 (promoter sells orange groves and company

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2/ See also United Housing Foundation, Inc. v. Forman, 421 U.S. 837, 852 (1975)(describing the third prong of the test as "a reasonable expectation of profits to be derived from the entrepreneurial or managerial efforts of others"); SEC v. Glenn W. Turner Enterprises, Inc., 474 F.2d 476, 482 (9th Cir.), cert. denied, 414 U.S. 821 (1973)(test is whether efforts made by those other than investors are the "undeniably significant ones").

affiliated -- under "direct common control" -- with promoter offers to grow, harvest, and sell oranges); Cameron v. Outdoor Resorts of America, Inc., 608 F.2d 187 (5th Cir. 1979) (promoter sells condominium campsites and retains exclusive right to rent campsites in owner's absence and share profits with owner); Wooldridge Homes v. Bronze Tree, 558 F. Supp. 1085 (D. Colo. 1983) (promoter sells unimproved resort property and promises to build condominiums and arrange for management services for two years); Hodges v. H & R Investments, 668 F. Supp 545 (N.D. Miss. 1987)(promoter of condominium guarantees buyer minimum rental income and promises to pay referral fee to buyer). As one commentator has noted, the typical situation that gives rise to an investment contract is the sale of property "accompanied by an arrangement under which the promoters * * * manage the entire operation and allocate the profits, if any, on the basis of the individual's relative participation." H. Bloomenthal, Securities and Federal Corporate Law (rev. ed. 1987), 2.04[1].

An affiliation or selling arrangement requirement stems from the nature of an investment contract. An investment contract requires both an investment of money and an expectation of profits from the efforts of others. An investment of money in the purchase of a condominium is not, in itself, a securities transaction, nor is the independent procurement of management services from others. Unless there is a link between the seller of the property (or his agent) and the provider of services,

these are two separate transactions, and the property sale is not covered by the securities laws. See Blackwell v. Bentsen, 203 F.2d 690, 693 (5th Cir.), cert. dismissed, 347 U.S. 925 (1953) (finding an investment contract where the sales of citrus groves and the offering of management services, "although separate in form," "form constituent parts of what is essentially one transaction").

Since in this case there is no suggestion of any affiliation or selling arrangement between the sellers of the condominium (or the real estate agent) and the operator of the rental pool, the sale of the condominium was not a transaction that involved an investment contract. 3/

3/ We are limiting our conclusion that there must be an affiliation or selling arrangement to the context of residential real estate, in light of its unique characteristic, noted in the case law, of providing a place to live (see, e.g., United Housing Foundation, Inc. v. Forman, 421 U.S. 837 (1975)). We are not expressing a view as to whether an affiliation or selling arrangement is necessary in all other types of cases, except to note that in other cases the management services must at least be "related" in some manner to the activities of the promoter. See Bloomenthal, Securities and Federal Corporate Law, (rev. ed. 1987) 2.04[11].

We also express no view as to who has the burden of proof on the linkage issue, or what will satisfy that burden so as to require the other side to go forward. We note, however, that it could be an easy evasion of the federal securities laws for a condominium seller and a rental pool operator to avoid formal documentary arrangements between themselves and nonetheless have an understanding, by custom and usage or otherwise.

B. Commission Release 5347, on which the panel relied in concluding that a security was sold here, applies to sales of condominiums by developers who have an affiliation or selling arrangement with a rental pool operator, not to a resale by an owner who has no such arrangement.

The Commission's view that the transaction at issue here did not involve the sale of a security is consistent with the position taken by the Commission in Release 5347. The release notes that "[t]he offer of real estate as such, without any collateral arrangements with the seller or others, does not involve the offer of a security." 1 Fed. Sec. L. Rep. (CCH) para. 1049 at 2071. However, the release states, "[w]hen the real estate is offered in conjunction with certain services, a security, in the form of an investment contract, may be present." Id. One such service noted in the release is a rental pool. 4/

4/ The release also discusses two other types of services that will cause an offering to be viewed as an offering of securities. The pertinent section of the release reads in full (1 Fed. Sec. L. Rep. (CCH) para. 1049 at 2072):

> In summary, the offering of condominium units in conjunction with any one of the following will cause the offering to be viewed as an offering of securities in the form of investment contracts:
>
> 1. The condominiums, with any rental arrangement or other similar service, are offered and sold with emphasis on the economic benefits to the purchaser to be derived from the managerial efforts of the promoter, or a third party designated or arranged for by the promoters, from rental of the units.
>
> 2. The offering of participation in a rental pool arrangement; and

(continued...)

The release does not state, however, that the mere contemporaneous offer of a rental pool is sufficient to meet the investment contract test. The very first sentence of the release makes clear that it applies where the condominium sale is "coupled with" the pool. Id. at 2070. Where the condominium seller and the rental pool operator have no affiliation or selling arrangement, there is no such "coupling."

Moreover, the release states that it applies to "persons engaged in the business of building and selling condominiums and similar types of real estate." Id. at 2070 (emphasis added). In other words, the release applies to developers, who, as is often the case in resort areas, have an affiliation or selling arrangement with a rental pool operator. The release does not apply to persons who resell their own individual units after the initial project is complete and have no such affiliation or selling arrangement with the pool operator.

The Commission's staff has expressed that understanding of the release on numerous occasions. Subsequent to the issuance of the Commission's release, persons involved in developing real estate projects have frequently sought the informal advice of the

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4/(...continued)

> 3. The offering of a rental or similar arrangement whereby the purchaser must hold his unit available for rental for any part of the year, must use an exclusive rental agent or is otherwise materially restricted in his occupancy or rental of his unit.

Commission's Division of Corporation Finance as to whether the Division would recommend Commission enforcement action if the property were sold without complying with the registration provisions of the Securities Act. The Division has declined to take a "no-action" position where there is an affiliation or selling arrangement between the developer and the rental pool operator. See, e.g., Little Squaw Mountain Township (April 25, 1973)(rental pool operated by subsidiary of the developer); Inter-Mack - Pali Ke Kua Condominiums (March 29, 1974)(rental pool operated by agent employed by the developer). Where, however, no such affiliation or selling arrangement is present, the Division has taken a no-action position. See Terrace Hills Condominium (September 29,1983) (optional rental pool available from the Board of Directors of the Homeowners Association, an entity that had no business relationship with the developer). 5/

5/ The only possible exception to this approach is Embarcadero, [1976-77] Fed. Sec. L. Rep. (CCH) para. 80,956 (Dec. 3, 1976), which the panel cited for the proposition that a condominium owner who participates in a rental pool cannot "uncouple" the condominium from the rental pool. See 839 F.2d at 570. There, the Division of Corporation Finance declined to take a no-action position as to a transaction involving the resale of a condominium in which participation in the original rental pool offered by the developer terminated upon resale and the new purchaser had to apply to enter the pool. The Embarcadero letter contains little discussion, and it cannot be determined whether there was an affiliation or selling arrangement between the seller of the condominium and the rental pool operator. Assuming there was no such relationship, Embarcadero is a statement of the staff in 1976 with which the present staff and the Commission

(continued...)

CONCLUSION

For the foregoing reasons, the Commission believes that the availability of a condominium rental pool does not make the sale of the condominium a securities transaction where the condominium seller has no affiliation or selling arrangement with the rental pool operator.

Respectfully submitted,

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5/(...continued)
disagree. See 17 C.F.R. 202.1(d) ("opinions expressed by members of the staff do not constitute an official expression of the Commission's views.")